SUPREME COURT OF THE UNITED STATES.

MOUNTAIN STATES SECURITIES CORPORATION,
Petitioner,

vs.

PERRY O. HOOPER, as Trustee of Bankrupt
CONSOLIDATED AMERICAN INDUSTRIES, INC.,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

JACK GRESHAM,
[illegible]

JOS. F. JOHNSTON,
[illegible]

JAMES C. BARTON,
[illegible]

A. POUNTREE, III,
[illegible]

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IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1960.

No. .....

MOUNTAIN STATES SECURITIES CORPORATION et al.,
Petitioners,

v.

PERRY O. HOOPER, as Trustee in Bankruptcy of
CONSOLIDATED AMERICAN INDUSTRIES, INC.,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Petitioners Mountain States Securities Corporation, Bruce Kistler, G. Harold Pearson, Ivor C. Peterson, Hoch Reid, and Francis J. Knoll, pray that a writ of certiorari issue to review the judgment of the Court of Appeals for the Fifth Circuit entered in the above-entitled case on July 12, 1960.

OPINIONS BELOW.

The opinion and judgment of the District Court for the Middle District of Alabama (R. 96) is unreported and is printed in Appendix A hereto, *infra*, p. 19. The opinion of the Court of Appeals for the Fifth Circuit (R. 121-144), together with the judgment of the court (R. 145), is printed in Appendix B hereto, *infra*, p. 24. The opinion of the Court of Appeals is reported in 282 F. 2d 195.

JURISDICTION.

The judgment of the Court of Appeals for the Fifth Circuit was made and entered on July 12, 1960 (R. 145). Petitions for rehearing were filed within the time permitted by the rules of that court (R. 146-167), and rehearing was denied on September 26, 1960 (R. 168). The jurisdiction of this Court is invoked under 28 U. S. C., § 1254 (1).

QUESTIONS PRESENTED.

1. Whether the delivery, by a corporation's stock transfer agent, of a stock certificate representing theretofore unissued shares of the corporation constitutes a "sale" of securities within the meaning of §§ 3 (a) (14) and 10 (b) of the Securities Exchange Act when such delivery is made: (i) without consideration, (ii) in reliance upon a fictitious corporate resolution purportedly authorizing the issuance of the stock, and (iii) without the authorization or knowledge of the corporation or its officers.

2. Whether Section 10 (b) of the Securities Exchange Act, as implemented by Rule X-10B-5 of the Securities and Exchange Commission, creates substantive rights for the benefit of an issuing corporation, giving to such corpora-

tion a private right of action when it issues previously unissued stock as a result of acts constituting a violation of § 10 (b).

3. Whether the transmission, from outside the state of Alabama, of a misrepresentation which is received in the Middle District of Alabama constitutes an "act or transaction" which, within the meaning of § 27 of the Securities Exchange Act, "occurs" in the Middle District of Alabama so that, if the misrepresentation is otherwise violative of the Act, an action under § 27 may be brought in that district.

4. Whether Section 11 (e) of the Bankruptcy Act extends the time within which a trustee in bankruptcy may bring an action based upon fraud for a period of two years after the discovery of the fraud even though: (i) the applicable state statute of limitations (Ala. Code, tit. 7, §§ 26, 42) bars such action after one year from the discovery of the fraud and (ii) the trustee in fact discovered the fraud more than one year prior to the bringing of such action, and (iii) the trustee brings such action more than two years after the adjudication of bankruptcy.

5. Whether an action based upon an alleged violation of § 10 (b) of the Securities Exchange Act may be brought in the Middle District of Alabama when the only act alleged to have occurred in that district was a misrepresentation which was made by a non-defendant without the knowledge of the defendants and which the complaint affirmatively shows had no connection with the alleged violation of § 10 (b).

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations directly involved are, in their pertinent parts, as follows:

A. Section 3 (a) (14), Securities Exchange Act of 1934, c. 404, 48 Stat. 881, 882, 15 U. S. C., § 78c (a) (14):

> "When used in this chapter, unless the context otherwise requires
>
> • • •
>
> "(14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

B. Section 10 (b), Securities Exchange Act of 1934, c. 404, 48 Stat. 881, 891, 15 U. S. C., § 78j (b):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
>
> • • •
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

C. Rule X-10B-5 of the Securities and Exchange Commission, 17 CFR 240.10b-5:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of

interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

D. Section 27 of the Securities Exchange Act of 1934, c. 404, 48 Stat. 881, 902, 15 U. S. C., § 78aa:

"The district courts of the United States, the United States District Court for the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or to enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant

may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against it in the Supreme Court or such other courts."

E. Act of June 25, 1948, c. 645, 62 Stat. 826, as amended, 18 U. S. C. A., § 3237 (Supp. 1959):

"* * * Any offense involving the use of the mails, or transportation in interstate or foreign commerce, is a continuing offense and, except as otherwise expressly provided by enactment of Congress, may be inquired of and prosecuted in any district from, through, or into which such commerce or mail matter moves."

F. Section 11 (c) of the Bankruptcy Act of 1898, as amended, 52 Stat. 840, 849, 11 U. S. C., § 29 (c):

"A receiver or trustee may, within two years subsequent to the date of adjudication or within such further period of time as the Federal or State law may permit, institute proceedings in behalf of the estate upon any claim against which the period of limitation fixed by Federal or State law had not expired at the time of the filing of the petition in bankruptcy. * * *"

G. Ala. Code, tit. 7, § 26 (1940):

"The following must be commenced within one year:

* * *

"Actions for any injury to the person or rights of another, not arising from contract, and not hereinafter specifically enumerated."

H. Ala. Code, tit. 7, § 42 (1940):

"In actions seeking relief on the ground of fraud where the statute has created a bar, the cause of action must not be considered as having accrued until the discovery by the aggrieved party of the fact constituting the fraud, after which he must have one year within which to prosecute his suit."

STATEMENT.

This action was brought by the respondent as trustee in bankruptcy of Consolidated American Industries, Inc., a Delaware corporation (R. 2). The complaint was filed on November 25, 1959, in the United States District Court for the Middle District of Alabama, although none of the defendants (petitioners herein) was a resident of Alabama (R. 2). The theory of the complaint was that the petitioners had violated § 10 (b) of the Securities Exchange Act of 1934, 15 U. S. C., § 78j (b), as implemented by Rule X-10B-5 of the Securities and Exchange Commission, and that the bankrupt corporation had been damaged thereby. Jurisdiction was based solely upon § 27 of the Securities Exchange Act, 15 U. S. C., § 78aa (R. 3). Under color of § 27, which permits extraterritorial service of process, respondent caused all petitioners to be brought into a court far distant from their homes and places of business, and there to defend charges which the petitioners claim to be false (R. 111-116).

The relevant allegations of the complaint were that in the fall of 1956, about three years prior to the commencement of the action, the petitioners conspired to procure without consideration the delivery to them of 700,000 shares of the unissued capital stock of Consolidated, the now bankrupt corporation (R. 9-14). According to the allegations of the complaint, this stock was procured in the following manner. Some of the petitioners, acting

together in the State of New York in December, 1956, prepared, certified, and delivered to the stock transfer agent of Consolidated a fictitious corporate resolution authorizing the issuance of 700,000 shares of stock in exchange for the assets of a corporation known as Mid-Atlantic Development Company (R. 10-12). In reliance upon this resolution the stock transfer agent, an independent corporation, delivered to the petitioners a certificate for 700,000 shares (R. 13). None of the alleged conspirators was at that time an officer, agent, or employee of Consolidated, and none of them had any authority to act in behalf of Consolidated (R. 5, 6, 11, 12). The corporate resolution was an entire fiction and had never been adopted by the Board of Directors of Consolidated (R. 12). The entire transaction "took place without the knowledge or authority" of the officers and directors of Consolidated (R. 13).

The only allegation of the complaint with respect to the "use of any means or instrumentality of interstate commerce or of the mails", or with respect to the occurrence of an "act or transaction" in the forum district, was that on November 15, 1956, the former president of Consolidated (who was not named as a defendant), while outside the State of Alabama, made misrepresentations to officers of Consolidated within the Middle District of Alabama in order to procure the sum of $10,000 (R. 9).

The petitioners filed motions to dismiss the complaint and to quash the returns of service (R. 24, 29, 31, 34, 74). On January 22, 1960, the district court entered its order granting the motions of the petitioners (R. 96). The district court, relying upon *Howard v. Furst*, 238 F. 2d 790 (2nd Cir. 1956), *cert. denied*, 353 U. S. 937 (1957), held that an issuing corporation, not being an investor within the meaning and protection of § 10 (b) of the Securities Exchange Act, did not have a private right of action under

that statute (R. 100; *infra*, p. 23). Because of the basis of its decision, the district court did not reach the other questions raised by the motions to dismiss.

Upon appeal, the court below granted leave to the Securities and Exchange Commission to participate as *amicus curiae* (R. 118, 119). With one dissent, the court below reversed and remanded (R. 145). Although the court recognized that the respondent had to show a purchase or sale of securities in order to invoke § 10 (b) and Rule X-10B-5, and although the court conceded that the complaint did not show a sale in the "common law traditional sense" (R. 131; *infra*, p. 33), the court held that the delivery of the stock certificate constituted a "sale" within the meaning of §§ 3a (14) and 10 (b) of the Securities Exchange Act because it constituted an "arrangement" in which stock was " 'otherwise dispose[d] of' " (R. 131; *infra*, p. 33).

The court also held that the alleged misrepresentations made by the former president of Consolidated in order to procure the $10,000 (R. 9-10) constituted an "act or transaction constituting the violation" of § 10 (b) of the Securities Exchange Act and that such act or transaction "occurred" within the Middle District of Alabama, so that suit could be brought in that district under § 27 of the Act. It reached this result by reading into the Securities Exchange Act the provisions of 18 U. S. C. § 3237 (R. 136; *infra*, p. 37).

The court below also recognized that the applicable statute of limitation was *Ala. Code*, tit. 7, §§ 26, 42 (1940), which bars an action based upon fraud after one year from the discovery thereof (R. 139-140; *infra*, pp. 38-39). Although the complaint affirmatively showed that the respondent trustee had discovered the fraud more than one year prior to the bringing of the action (R. 94) and that

the action was commenced more than two years after the adjudication of bankruptcy (R. 2), the court held that § 11 (e) of the Bankruptcy Act means that the trustee has two years from the discovery of the fraud to bring an action based thereon (R. 138, *infra*, p. 39).

Within the time limits permitted by the rules of the court below the several petitioners filed applications for rehearing (R. 146-167). Rehearing was denied, one judge dissenting, on September 26, 1960 (R. 168).

REASONS FOR GRANTING THE WRIT.

I.

The court below sustained the proposition that a violation of § 10 (b) of the Securities Exchange Act, as implemented by Rule X-10B-5 of the Securities and Exchange Commission, gives rise to a private right of action and further held the delivery of a stock certificate by the stock transfer agent of an issuer corporation in reliance upon a fictitious corporate resolution, while not involving a "sale" in the true sense, was a dispositive arrangement constituting a violation of § 10 (b). In these respects the decision of the court below involves important questions of federal law which have not been, but should be, settled by this Court.

By its express language, § 10 (b) is limited to transactions involving the "purchase or sale of securities." There can be no violation of § 10 (b) and Rule X-10B-5, and no jurisdiction under § 27 of the Act, in absence of such purchase or sale. Despite this clear statutory language, the court below held that it is enough to show "an arrangement" in which securities are "'otherwise disposed of'" (R. 131; *infra*, p. 33). The phraseology "otherwise

disposed of" is taken out of context from § 3 (a) (14) of the Act, which defines the word "sale" to include "any contract to sell or otherwise dispose of". In the case at bar the complaint does not show a "contract to dispose of"; nor did the court below so hold. The effect of the holding of the court below is that *any arrangement* involving the disposal of stock, whether it is contractual or not, constitutes a sale within §§ 3 (a) (14) and 10 (b) of the Act. This would include an arrangement by which stock is obtained by embezzlement, procured by a forged assignment, or devised by an unduly influenced testator. Although there are remedies for such "arrangements", Congress did not intend to include such remedies within the Securities Exchange Act.

Because of the nationwide service of process permitted by § 27 of the Act, the extraordinary and unprecedented scope now given to § 10 (b) and Rule X-10B-5 constitutes an open invitation to vexatious civil litigation, harassment, and the seeking of settlements based only on the avoidance of trial expense at distant locales. This raises "deep issues of public policy in the light of which legislation must be construed." *United States v. Johnson*, 323 U. S. 273, 276 (1944). In addition, because of the criminal and injunctive provisions of the Act (§§ 21 and 32, 15 U. S. C., §§ 78u, 78ff), the decision below is of great importance in the administration of the Act. This is evidenced by the intervention of the Securities and Exchange Commission as *amicus curiae* (R. 118).

II.

The court below construed § 10 (b) of the Securities Exchange Act as giving rise to a private right of action in favor of an issuing corporation. The decision in that respect is in conflict with the principle upon which the Second Circuit decided the case of *Howard v. Furst*, 238 F. 2d 790 (1956), *cert. denied* 353 U. S. 937 (1957), and in-

volves an important question of federal law which has not been, but should be, decided by this Court.

The Securities Exchange Act does not expressly permit a civil suit by persons injured as a result of a violation of § 10 (b). This is in marked contrast to §§ 9, 16 and 18, 15 U. S. C., §§ 78i, 78p, 78r, in which civil liabilities are expressly provided. Any liability under § 10 (b) is an implied liability and is based upon the theory that the violation of a statute gives a right of action to a person injured by such violation if (i) the intent of the statute is to protect the insured person as an individual and (ii) the interest invaded by the violation is an interest which the statute is intended to protect.[1] Stated differently, the plaintiff must be a member of the class for whose protection the statutory duty is created. To the extent that the statute is designed to protect the interests of the state or the public as a whole, violation results in no civil liability. See, generally, *Restatement of Torts*, §§ 286-288; *Loss, Securities Regulation* 1044 (1951).

Section 10 (b) provides, when the jurisdictional conditions are present, that it shall be unlawful to employ fraud "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or *for the protection of investors.*"[2] Thus, the class of persons intended to be protected by § 10 (b), as distinguished from the general public, is a class composed of "investors." It is clear that an issuing corporation—that is, a corporation issuing theretofore unissued stock as distinguished from a corporation selling stock held in its investment portfolio—is not an investor

[1] See Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E. D. Pa. 1946), which is the landmark case with respect to private actions under § 10 (b).

[2] Emphasis added

within the meaning and protection of § 10 (b). This was recognized in principle in *Howard v. Furst*, 238 F. 2d 790 (2d Cir. 1956), *cert. denied*, 353 U. S. 937 (1957), in which, in a derivative suit by stockholders, a corporation sought to assert a private right of action under § 14 (a) of the Securities Exchange Act, 15 U. S. C. § 78n (a). Section 14 (a), like § 10 (b), provides that it shall be unlawful to take certain action (i. e., solicit proxies) "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest *or for the protection of investors.*"[3] It was alleged in the complaint that the defendant had violated such rules and that the corporation had suffered damage as a result thereof. As in the case at bar, jurisdiction was based solely on § 27 of the Act. In affirming a dismissal of the complaint, the Second Circuit said:

> ". . . Here the statute authorizes the formulation of rules and regulations 'in the public interest or for the protection of investors.' There is literally nothing to support the view that any substantive rights were created for the benefit of the corporation."[4]

The legislative reason for omitting issuers from the protection of § 10 (b) is made clear by the case at bar. Here, under the law of the state of incorporation, there is adequate protection for the corporation. Under the facts alleged the stock procured from the stock transfer agent would seem to be entirely void, just as in the case of forged stock. At worst, since there was no consideration for the stock, the stock could have been cancelled, either by the corporation or through a derivative suit. *Del. Const.*, art. IX, § 3; *Del. Code*, tit. 8, §§ 152, 163, 164; *Baker v. Bankers' Mortgage Co.*, 15 *Del. Ch.* 183, 133 Atl. 608 (1926).

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[3] Emphasis added.

[4] 238 F. 2d 790, 793.

The question of whether § 10 (b) of the Securities Exchange Act creates substantive rights for the benefit of an issuer is an important question affecting the administration of the Act and should be passed on by this court.

III.

The court below held that the interstate transmission of a misrepresentation which was received in the Middle District of Alabama was an "act or transaction constituting the violation" of the Securities Exchange Act and that such act or transaction occurred in the Middle District of Alabama, so that suit could be brought in that district under § 27 of the Act. In that respect the decision of the court below is in conflict with the principles adopted by this Court in *United States v. Johnson*, 323 U. S. 273 (1944).

The prohibition of § 10 (b) is against using or employing (by use of any means or instrumentality of interstate commerce or of the mails) any manipulative or deceptive device. The offense occurs in the district in which manipulative or deceptive device is transmitted, not in the district in which it is received. In holding to the contrary the court below declined to follow the principles set forth in *United States v. Johnson*, 323 U. S. 273 (1944), in which this Court held, in the context of a prosecution for violation of the Federal Denture Act, 56 Stat. 1087, 18 U. S. C. § 420, that the receipt of an item of commerce in a particular district was not an offense by the sender in that district. Instead, the court below read into § 27 of the Securities Exchange Act the provisions of Act of June 25, 1948, c. 645, 62 Stat. 826, as amended 18 U. S. C. A. § 3237 (Supp. 1959), which provides in relevant part:

> "Any offense involving the use of the mails, or transportation in interstate or foreign commerce, is

a continuing offense and, except as otherwise expressly provided by enactment of Congress, may be inquired of and prosecuted in any district from, through, or into which such commerce or mail matter moves."

In view of the grave injustices which are made possible by the nationwide service of process provisions of § 27, and in view of the policy considerations set forth in *United States v. Johnson*, 323 U. S. 273 (1944), the question of whether 18 U. S. C., § 3237, can be read into the Securities Exchange Act is of sufficient importance to warrant the attention of this Court. The possibility of injustice is made clear in the case at bar, where none of the petitioners resides or transacts business in Alabama. The only act alleged to have occurred in Alabama was a misrepresentation by a person not named as a defendant to the effect that Consolidated owned certain stock in a Cuban insurance company and that $10,000 was needed to protect this investment (R. 9). The complaint alleged by way of conclusion (R. 14) that this was a material part of the fraudulent procurement of the 700,000 shares of stock. However, the factual averments of the complaint directly contradict this and show that the delivery of the stock certificate was made in sole reliance upon a fictitious corporate resolution and was in no way connected with the alleged misrepresentation by which the $10,000 was procured (R. 10-13). Whatever may be the leniency with which complaints are construed under federal practice, to permit extraterritorial process upon a conclusion of the pleader, when the pleaded facts expressly negative such conclusion, results in gross injustice where, as here, the defendants are brought into court from distant places.

IV.

The court below construed Section 11 (e) of the Bankruptcy Act, 11 U. S. C., § 29 (e), to extend the time for

filing actions based upon fraud until two years after the discovery of the alleged fraud even though such period expires more than two years after the adjudication of bankruptcy and even though the applicable state statute permits such action to be brought only within one year after discovery. In this respect the decision below raises an important question which has not been, but should be, decided by this court in regard to the administration of the Bankruptcy Act.

In the case at bar the applicable statute of limitation was Ala. Code, tit. 7, §§ 26, 42 (1940), *supra*, pp. 6-7. This statute bars actions based upon fraud if brought more than one year after the discovery of the fraud. In the case at bar the respondent trustee discovered the fraud more than one year prior to bringing his action (R. 94). Thus, he could have brought the action (i) within one year after such discovery or (ii), under § 11 (e) of the Bankruptcy Act, "within two years subsequent to the date of adjudication", whichever period last expired. This he failed to do.

The court below based its decision on *Dabney v. Levy*, 191 F. 2d 201 (2d Cir. 1951), which the petitioners concede to be in point. However, the decision in *Dabney v. Levy* is based upon a misreading of the statute which was before this Court in *Bailey v. Glover*, 21 Wall. 342, 22 L. Ed. 636 (1875). In that case Section 2 of the Bankruptcy Act of 1867 (14 Stat. 536) provided that the assignee in bankruptcy had to bring all actions within "two years from the time the cause of action accrued" for the assignee. This Court simply held that a cause of action based on fraud does not accrue until discovery. Section 11 (e) of the current Bankruptcy Act does not relate to the accrual of causes of action, which is determined under state law, but merely protects the trustee in the event that the limitation falls within the two-year period after adjudication.

The error contained in *Dabney v. Levy* and in the decision of the court below will be of serious consequence to trustees in bankruptcy relying thereon.

CONCLUSION.

For the foregoing reasons petitioners pray that this petition for a writ of certiorari be granted.

Respectfully submitted,

.....

JACK CRENSHAW,
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.....

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.....

JAMES C. BARTON,
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Attorneys for Petitioners.

Proof of Service.

I, Jos. F. Johnston, one of the attorneys for Mountain States Securities Corporation, Bruce Kistler, G. Harold Pearson, Ivor C. Peterson, Hoch Reid and Francis J. Knoll, petitioners herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the

..... day of December, 1960, I served copies of the above and foregoing Petition for Writ of Certiorari as follows:

1. On Perry O. Hooper, as trustee in bankruptcy of Consolidated American Industries, Inc., by mailing a copy in a duly addressed envelope with first class postage prepaid, to his attorney of record, Albert W. Copeland, Esq., Godbold, Hobbs & Copeland, 300 Professional Center, Montgomery, Alabama.

2. On the Securities Exchange Commission, by mailing a copy in a duly addressed envelope with air mail postage prepaid, to Thomas G. Meeker, its general counsel, at the offices of the Commission, Washington 25, D. C.

.....
Attorney for Petitioner.

902 First National Building,
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APPENDIX A.

OPINION AND JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE MIDDLE DISTRICT OF ALABAMA.

In The District Court of The United States For The Middle District of Alabama, Northern Division

Perry O. Hooper, as Trustee in Bankruptcy of Consolidated American Industries, Inc., Plaintiff, vs. Mountain States Securities Corporation, Bruce C. Kistler, Hoch Reid, Robert C. Whitaker, G. Harold Pearson, Ivor C. Peterson and Francis J. Knoll, Defendants.	Civil Action No. 1566-N.

Order Granting Motions to Dismiss and Quash.

This cause is brought by the plaintiff in his capacity as Trustee in Bankruptcy of Consolidated American Industries, Inc., and in this action plaintiff brings, liability is sought to be imposed separately and severally upon the defendants Mountain States Securities Corporation, Bruce C. Kistler, Hoch Reid, Robert C. Whitaker, G. Harold Pearson, Ivor C. Peterson, and Francis J. Knoll. All of these defendants are nonresidents of Alabama and each, with the exception of Whitaker, has been served and appears in this cause.

This cause is now submitted upon the motions of the defendants Mountain States, Kistler, Pearson and Peterson, made separately and severally, wherein they seek to have

this Court quash the service of process served upon them; and also upon the motions to dismiss made by the defendants Knoll, Reid, Mountain States, Kistler, Pearson and Peterson, separately and severally.

Plaintiff's factual theory of this action is that certain false and fraudulent representations were made on or about November 15, 1956, by an individual named Ben Jack Cage to the officers then controlling Consolidated American Industries, Inc., and that by reason of said false and fraudulent representations Consolidated American issued 700,000 shares of its stock that plaintiff says were valued at $1.00 per share, and said issuance by reason of said false and fraudulent representations resulted in a loss to Consolidated American Industries, Inc., of $700,000. This is the sum for which plaintiff now sues these defendants. Plaintiff alleges a conspiracy (with Cage) on the part of these defendants to defraud Consolidated American Industries of its stock, and alleges that some of the transactions occurred within this district.

Plaintiff predicates his action upon the legal theory that these alleged false and fraudulent acts by these defendants constituted a violation of § 10 (b) of the Securities Exchange Act (15 U. S. C. A. § 78j) as said Act is implemented by Rule X-10-B-5 of the Securities and Exchange Commission, and that this Court has jurisdiction of this cause of action and jurisdiction over the parties to said cause by reason of § 27 of said Act (15 U. S. C. A. § 78aa). The theory of the defendants' motions to dismiss and quash is that there is no jurisdiction over the person of the defendants in this district because the complaint does not state a cause of action under the Securities Exchange Act and the extraterritorial service of process upon the defendants is void and of no effect.

For the reasons hereinafter set out, this Court is of the opinion that the defendants' motions are well taken and

that the service of process upon each of the defendants who have been served should be quashed and the cause should be dismissed as to each defendant so moving.

Section 10 (b) of the Act provides, in substance, that it shall be unlawful for any person, directly or indirectly, by the use of any means of interstate commerce, or the mails, to use, in connection with the purchase or sale of any security, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. For the purpose of implementing that section of the Act, the Securities and Exchange Commission promulgated its Rule X-10-B-5, which follows very closely the language of § 17 of the Securities Act of 1933 (15 U. S. C. A. 77q). This rule provides, in substance, that it shall be unlawful for any person, in connection with the purchase or sale of any security, to make any untrue statement, or engage in any fraudulent act or practice.

Section 27 (15 U. S. C. A. § 78aa) of the Act is the jurisdictional section. It provides, in substance, that the district courts of the United States shall have exclusive jurisdiction of violations of and over actions brought to enforce any liability or duty created by the Act, or the rules and regulations promulgated thereunder. It provides, further, that such actions may be brought in the district wherein any act or transaction constituting the alleged violation occurred, or in the district wherein the defendant is found or is an inhabitant or transacts business. In other words, when there has been a violation as provided by the Act and an action for that violation is properly brought, the normal territorial limits relating to service of process are not applicable. See *Wright v. Securities and Exchange Commission*, 1940, 2 Cir., 112 F. 2d 89, 95; *Connelly v. Balkwill*, 1959, D. C. Ohio, 174 F.

Supp. 49; *Slavin v. Germantown Fire Ins. Co.*, 1949, 3 Cir., 174 F. 2d 799.

Even though § 10 (b) of the Act does not expressly provide for a substantive civil remedy, the Federal courts have generally agreed and held that a civil action may be brought by a private person to enforce that section of the Act as that section is implemented by Rule X-10-B-5. See *Slavin v. Germantown Fire Ins. Co.*, supra; *Fratt v. Robinson*, 1953, 9 Cir., 203 F. 2d 627; *Errion v. Connell*, 1956, 9 Cir., 236 F. 2d 447. The theory upon which these courts have predicated their conclusion is that of an implied liability for violations to injured persons, if the interest of the injured person is an interest which the statute is intended to protect. See *Kardon v. National Gypsum Co.*, D. C., Pa., 1946, 69 F. Supp. 512.

Consolidated American Industries, as the issuing corporation of the 700,000 shares of its stock, now suing through the Trustee in Bankruptcy, cannot maintain such action. The same conclusion was reached by the United States Court of Appeals for the Second Circuit, speaking through Judge Medina, in the case of *Howard v. Furst*, CCA 2, 1956, 238 F. 2d 790, wherein the court stated:

> "As the case is said to be one 'arising under' the laws of the United States, our first inquiry is addressed to appellant's contention that the statutory provisions above quoted create or give rise to a substantive civil right on behalf of Circle [the corporation], which may be enforced in a derivative action by an individual stockholder. We reject this contention as unsound. We find nothing in the language of Section 14 (a) or in the legislative history of the Securities Exchange Act of 1934 to warrant an inference that it was the intention of the Congress to create any rights whatever in a corporation whose stockholders may be solicited by proxy statements

prepared in contravention of the statutory mandate.

"* * * Here the statute authorizes the formulation of rules and regulations 'in the public interest or for the protection of investors.' There is literally nothing to support the view that any substantive rights were created for the benefit of the corporation."

The Circuit Court in *Howard v. Furst*, affirmed the decision of the district court, which decision is reported in 140 F. Supp. 507. The district court in dismissing the complaint stated:

"It was the individual investor who was without effective recourse prior to the enactment of the statute. There is no suggestion that Congress found the rights of the corporation, as already protected by derivative action, inadequately provided for."

The fact that the *Howard v. Furst* case concerned § 14 (a) does not render it inapplicable to the case now before this Court.

For the foregoing reasons and for good cause shown, it is the Order, Judgment and Decree of this Court that the motions to dismiss, filed separately and severally by the defendants Knoll, Reid, Mountain States Securities Corporation, Kistler, Pearson and Peterson, should be and each of said motions is granted. It is Ordered that this cause be and it is dismissed as to each of said defendants. It is furthered Ordered that the service of process upon each of said defendants be and the same is hereby quashed.

Done, this the 22nd day of January, 1960.

Frank M. Johnson, Jr.,
United States District Judge.

APPENDIX B.

OPINION AND JUDGMENT OF UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

In the
UNITED STATES COURT OF APPEALS
For the Fifth Circuit

No. 18218

Perry O. Hooper, As Trustee in Bankruptcy of Consolidated American Industries, Inc., Appellant,

versus

Mountain States Securities Corporation, et al., Appellees.

Appeal from the United States District Court for the Middle District of Alabama.

(July 12, 1960.)

Before Rives, Chief Judge, and Cameron and Brown, Circuit Judges.

Brown, Circuit Judge: In this civil action seeking relief for violation of §10(b) of the Securities Exchange Act, 15 USCA §78 et seq., 78j, and Rule X-10B-5 promulgated by the SEC, the principal question is whether a corporation misled by fraud in the issuance of its stock in return for spurious assets is a seller. Is the

transaction a sale? The District Court on motion to dismiss the complaint thought not. With that conclusion, the efforts to secure extraterritorial service of process under §27 of the Act for the trial in Alabama over defendants residing in other states automatically fell. Some subsidiary questions exist. These include the right of the bankruptcy Trustee to sue for fraud perpetrated on the corporate bankrupt and also the problem of applicable statutes of limitation. Faced also is a question whether the scheme was so neatly executed that there was no "seller" and no "purchaser." This is so, the argument runs, because although the issuing corporation parted with its shares, this was done through persons having no authority (hence not a "seller") and the acquiring corporation was liquidated prior to receiving the stock (hence not a "purchaser"). We hold the corporate issuer to be a seller and reverse.

I.

The Fraudulent Scheme.

Because the basic issue is broadly presented, we may capsulate the facts alleged which, for this motion, are deemed established. In doing so, however, we would emphasize that the complaint more than satisfied the requirements of the Federal Rules.[1] In its fourteen pages and the annexed five exhibits making up another ten pages, it sets forth in detail reminiscent of common law pleading names, places, dates and specific transactions. The sufficiency of the allegations of fraud under F.R.Civ.P. 9 is not challenged.

Plaintiff is the Trustee of Consolidated American Industries, Inc. The corporation had been under the dom-

[1] Conley v. Gibson, 1957, 355 U.S. 41, 47-48, 78 S.Ct. 99, 2 L.Ed.2d 80, 85-86; Millet v. Godchaux Sugars, 5 Cir., 1957, 241 F.2d 264; Carss v. Outboard Marine Corp., 5 Cir., 1958, 252 F.2d 690.

sination of the somewhat renowned Ben Jack Cage, now a Brazilian protected fugitive from Texas justice. On October 18, 1956, control of Consolidated passed into new hands located in Alabama. As a condition Cage was required to sever all connections with the affairs of Consolidated. This he formally did. But that is all, for he then became the central figure in a fraudulent scheme concocted with the other defendants to get Consolidated to issue 700,000 shares of its stock (par value 1¢ but having a current trading value of $1.00). Ostensibly leaving Consolidated, Cage went to Cuba where on behalf of another Cage enterprise (I.C.T.) he orally agreed to buy shares in a Cuban insurance company. This called for a down payment of $5,000 and an advance to the Cuban company of an additional $5,000 as a demand loan. This $10,000, although not then paid to the Cubans, cuts an important figure in this litigation. Winging his way back to Texas where he was then still a free man, Cage made another deal through a Corpus Christi trader to acquire oil exploration rights in Honduras.

The grand aim of Cage was to find a corporate vehicle through which these two contract rights could then be transferred to Consolidated in exchange for Consolidated stock which would thereafter be distributed in liquidation of the vehicle corporation. The Consolidated stock could then be disposed of by the individual distributees as regulation-free stock in ordinary over-the-counter operations. Here is where the defendant Mountain States Securities Corporation and the Denver individual defendants come in. This corporation in connivance with certain directors, stockholders and its counsel created Mid-Atlantic Development Company which was to serve as the vehicle corporation. The stock ownership of Mid-Atlantic was ultimately fixed at 4 7ths for Cage (or his nominees) and 3 7ths for the Denver group.

In the meantime, around November 15, 1956, in order to get I.C.T. to transfer to Mid Atlantic the rights to the Cuban insurance company stock, Cage had to scrape up $10,000 to comply with the initial Cuban deal. He did this by falsely representing to the new Alabama management of Consolidated then located in Montgomery, Alabama, that Consolidated already owned the Cuban insurance company stock, and that the Cuban company was in dire need of financing which, if not forthcoming from Consolidated, would result in loss of its investment. This took place by use of interstate long distance telephone facilities. This call was effective and Consolidated thereupon arranged for the $10,000 to be sent to Cuba.

Mid-Atlantic, now the owner of the rights to procure the Cuban insurance company stock and the Honduran exploration rights, formally contracted to transfer these to Consolidated in exchange for 700,000 shares of Consolidated stock. But as the new post-October Alabama management of Consolidated was not in on the deal, some way had to be found to get the Consolidated's New York City stock transfer agent to issue the 700,000 shares to Mid-Atlantic. Here is where the Pennsylvania defendant, the former secretary of Consolidated, and the New York defendant, its former general counsel, come in. In December, 1956 the former secretary falsely certified corporate resolutions purporting to approve as of October 18, 1956, the Mid-Atlantic transaction. The former general counsel falsely wrote a letter to the transfer agent concerning the Board of Directors' action in this transaction and stating his opinion that the issuance was exempt from SEC registration. At the time these actions were taken, each knew that he was no longer an officer of Consolidated, lacked authority to act in behalf of the corporation, and that the transaction was not as represented to the transfer agent. The transfer agent, acting pursuant to these corporate directions, issued the stock

in Mid-Atlantic's name and delivered the certificate to the former general counsel who in turn gave it to Cage. Mid-Atlantic had already been dissolved and new stock was issued in the name of the distributees (or nominees) of Mid-Atlantic. Of the 700,000 shares, over 400,000 were then sold by the distributees to individual investors throughout the world.

Accepting these allegations as sufficient—which they clearly were—to charge a fraudulent scheme resulting in the issuance of its own stock, the District Court held that Consolidated was not a seller, and that there had been no sale. The complaint was dismissed for failure to state a claim under the statute and regulation, and in the absence of such a claim, no ground existed for extraterritorial service of process on the nonresident defendants. The District Judge faced the issue squarely and decided it just as forthrightly. Now the defendants naturally assert other grounds which support the result even though we might disagree with the District Court's stated reason. Following tit for tat, the Trustee joins them with like energy. This has resulted in considerable preoccupation with the nature of the rights to stock in the Cuban insurance company and the Honduran oil exploration transactions. Whether either one or both of these amounted to a sale of a security by Mid-Atlantic and therefore a "purchase" by Consolidated, we need not decide since we are clear that Consolidated "sold" its own stock and to be a seller is enough. One need not be both.

II.

Issuing Corporation Is a Seller.

Issuance of Stock Is a Sale.

We need not repeat here the history now so well catalogued which traces the exercise by the SEC of the legis-

lative power granted in §10(b)[2] to promulgate regulation X-10B-5.[3] A significant purpose of X-10B-5 was to extend to *sellers* the same protection against fraudulent and other unlawful schemes afforded to those defrauded in th *purchase* of securities.[4] In a substantive way it is even more sweeping. It greatly expands the protection frequently so hemmed in by the traditional concepts of com-

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[2] Section 10(b), Securities Exchange Act of 1934

"It shall be unlawful for any person, directly or indirectly, by the use of any means or in trumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

• • • •

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 USCA §78j(b).

[3] Rule X-10B-5

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of inter-state commerce, or of the mails, or of any facility of any national securities exchange.

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 CFR 240.10b-5.

[4] Rule X-10B-5 was patterned upon the language of §17(a) of the Securities Act of 1933, 15 USCA §77q(a) but added words to cover fraud if perpetrated on sellers as well as purchasers. See Birnbaum v. Newport Steel Corp., 2 Cir., 1952, 193 F.2d 461; Fratt v. Robinson 9 Cir., 1953, 203 F.2d 627. Reference is also generally made to the excellent comment, "The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors," 59 YALE L. J. 1120, see especially 1121-1122 (1950). See also White, "Swindlers and the Securities Act," 45 ABAJ 29 (1959)

mon law misrepresentation and deceit, the requirement of privity, proof of specific damage, inadequacy of the right of rescission or right to recover up to par value of stock of a much greater market value. To these difficulties would have to be added the geographic obstacle of suit in a common forum against multi-state defendants scattered as far as the fraudulent device required.[5] And along with the Second, Third and Ninth Circuits,[6] we now adopt, as we earlier foreshadowed,[7] the principles set forth in the trail-blazer decision of *Kardon v. National Gypsum Co.*, E.D.Pa., 1946, 69 F.Supp. 512, that a violation of rule 10B-5 gives rise to a private right of action. And this private right of action arises where facilities of the mail or interstate communications are used in connection with the sale or purchase of securities even though the transaction is conducted directly between the buyer and seller and not through a securities exchange or an organized over-the-counter market.[8]

The argument against allowing recovery to a corporation issuing its own stock in exchange for a consideration, cash or property, runs somewhat this way. It is recognized that §10(b) is not self-executing. It only makes unlawful that which SEC forbids by "such rules and regulations as the Commission may prescribe as necessary or

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[5] 59 YALE L.J. 1120, 1123-26, 1137, 1131, 1138.

[6] Fischman v. Raytheon Mfg. Co., 2 Cir., 1951, 188 F.2d 783; Slavin v. Germantown Fire Ins. Co., 3 Cir., 1949, 174 F.2d 799; Fratt v. Robinson, 9 Cir., 1953, 203 F.2d 627; Errion v. Connell, 9 Cir., 1956, 236 F.2d 447.

[7] We recognized this principle in Reed v. Riddle Air Lines, 5 Cir., 1959, 266 F.2d 314, at 315, but relief was denied on the facts.

[8] Fratt v. Robinson, 9 Cir., 1953, 203 F.2d 627; Northern Trust Co. v. Essaness Theatres Corp., N.D.Ill., 1952, 103 F.Supp. 954; Robinson v. Difford, E.D.Pa., 1950, 92 F.Supp. 145; Speed v. Transamerica Corp., 3 Cir., 1956, 235 F.2d 369.

appropriate." See note 2, *supra*. But since the test of necessity or appropriateness is "the public interest or for the protection of investors," regulation X-10B-5 can give rise to a private right only in the event the "seller" or "purchaser" is an "investor." The forensic climax is that whatever else it might be, such an issuing corporation is not an investor.

But this argument is an artificial application of the concept that violation of a legislative standard gives those intended to be protected a private right of action provided the injury sustained is other than that suffered by the public generally. See, generally, Restatement of Torts, §§ 286-288. The SEC had ample power to promulgate this regulation. It had two bases—"in the public interest" or "for the protection of investors." Each fully justified the regulation. Its validity does not therefore depend on its being issued "for the protection of investors." Granted that interpretation and application of a regulation may not cover matters beyond the limits of its legislative source, an inability of one to bring himself within one specific statutory basis would not foreclose his right as to the other. That the other basis is "in the public interest" does not make all those intended to be protected by it have merely the standing of the public generally. Quite obviously the broad purpose of this legislation was to keep the channels of interstate commerce, the mail, and national security exchanges pure from fraudulent schemes, tricks, devices, and all forms of manipulation. Just as obviously those sought to be protected were the very persons who would be engaged in buying and selling and trading in corporate securities as broadly defined in the Act. Certainly a person who parts with stock owned by him as the result of fraudulent practices wrought on him by his purchaser sustains an adverse impact that differentiates

him from the damage suffered by the public generally. It is not essential, therefore, that for an issuing corporation to come under §10(b) and Rule X-10B-5 it have the status of an "investor" as such.

Freed of any implied limitation of "investor" status, does such corporation otherwise come within the section and the rule?

Certainly the regulation uses language which would comprehend an issuing corporation. It makes it unlawful for "any person * * * to employ any * * * scheme * * * to defraud, to make an untrue statement * * * or, to engage in any act * * * which operates * * * as a fraud or deceit upon any person * * *." See note 3, *supra*. The Act supplies its own definition to make a "person" encompass "a corporation." §3(a)(9); 15 USCA §78c(a)(9). If an issuing corporation is not within the regulation, it is not because it is not a "person." This means, then, that to exclude it from X-10B-5 it must be because there is no "sale of any security" and hence the issuer is not a "seller." Again, the first hurdle encountered is the wording of the statute. In the plain of language it provides that "the term 'security' means * * * any stock * * * or right to purchase * * * any [stock]. §(3)(a)(10), 15 USCA §78c(a)(10). What Consolidated issued was its own stock certificates in the usual form. This stock was a security within the statute and regulation and was the subject of the transaction between Consolidated and Mid-Atlantic.

The effort to escape the impact of X-10B-5 finally boils down to the assertion that the transfer of this admitted security could not have been a "sale." As before, the statute is remarkably rich in the legislative determination of critical terms. The Act provides that "the terms 'sale' and 'sell' each include any contract to sell or otherwise

dispose of." 3(a)(14), 15 USCA 78c(a)(14).[9] Certainly the transactions between Consolidated and the apparent transferee, Mid-Atlantic, had many earmarks of a sale. Mid-Atlantic had properties which it ostensibly valued highly. It was willing to trade these properties as consideration for the Consolidated stock. Consolidated, on the other hand, had its own stock which had a marketability of $1 per share. To the corporation it had the same economic value as would the proceeds received from a public issue of like shares to acquire property which it desired and which it had been led to believe was valuable. Before the transaction Consolidated had 700,000 shares of stock. After the transaction it no longer had the stock, but it had, or thought it had, the property. If this is not a sale in the strict common law traditional sense, it certainly amounted to an arrangement in which Consolidated "otherwise dispose[d] of" its stock. 3(a)(14), 15 USCA 78c(a)(14).

Even in our remote position, we would be blind to all we hear and read about were we to succumb to the artificial contention that the issuance of this stock made the corporation no poorer so that the only persons who suffered were the stockholders for whom the suit cannot be brought by the Trustee. It may be that Cash McCall is a fictional character, but his story is that of the post war business community in which from the ubiquitous quest of capital gains, the larger swallows up the small to become big only to become shortly swallowed up by the biggest. In this process, the thing of value transferred in exchange for assets or the capital stock of the enterprise being acquired is the capital stock of the acquiring cor-

[9] By their nature terms "sell" and "purchase" are correlative in many ways. The statute is equally broad as to "purchase." "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire." 3(a)(13), 15 USCA 78c(a)(13).

poration. Considering the purpose of this legislation, it would be unrealistic to say that a corporation having the capacity to acquire $700,000 worth of assets for its 700,000 shares of stock has suffered no loss if what it gave up was $700,000 but what it got was zero. If—as we very much doubt—accountants would support any such contention as a consequence of the esoteric mysteries of the double entry system, *Liston Zander Credit Co. v. United States*, 5 Cir., 1960, 276 F.2d 417, 422, the law with its eye on reality would have to part company with such purists.

Neither statutory terminology nor practical business legal considerations support the contention that, as a matter of law, Consolidated in issuing its stock was not a seller and the transaction was not a sale. All that is left is reliance upon statement[10] made by the Second Circuit in the course of its decision in *Howard v. Furst*, 2 Cir., 1956, 238 F.2d 790, cert. denied, 353 U.S. 937, 77 S.Ct. 814, 1 L.Ed.2d 759. We find it unnecessary and undesirable to undertake any criticism either of that decision or the comments made with respect to a civil action brought as a stockholders' derivative suit alleging a violation of §14(a) and Rule X-14A-9 on solicitation of proxies. We decline, as we think that Court would, to read into its language a holding that a corporation injured by a sale or purchase of securities has no private right of action under §10(b) and X-10B-5.

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[10] The portion of the opinion pressed successfully on the District Court reads this way. "There is literally nothing to support the view that any substantive rights were created for the benefit of the corporation." 238 F.2d 790 at 793. The District Judge below also quoted from the trial court's opinion, 140 F.Supp. 507, 512 affirmed by the Second Circuit. "It was the individual investor who was without effective recourse prior to the enactment of the statute. There is no suggestion that Congress found the rights of the corporation, as already protected by derivative action, inadequately provided for."

III.

Act of Transaction in Alabama.

A serious question yet remaining is whether the complaint sufficiently alleges acts occurring within the Middle District of Alabama. If it does, then the extra-territorial provisions in §27, 15 USCA §78aa, support service of process in Colorado, New York and Pennsylvania where the defendants reside.[1] None resides in Alabama.

The test for a civil action is that applicable to a criminal proceeding under the Act which "may be brought in the district wherein any act or transaction constituting the violation occurred." Of course that is not to say that a civil action with potential jurisdiction over nonresident defendants may not be maintained in circumstances where a criminal proceeding would fail. It does mean, however, that there must have been within the forum district acts constituting a civil violation of the particular statute or regulation giving rise to the private right of action.

Here the essence of the fraud is that the defendants confected a scheme to get Consolidated to issue 700,000 shares of stock for worthless property ostensibly owned by Mid-Atlantic in order that the individuals could divide up the Consolidated stock as loot and thereby reap the fruits of the fraud. What made this evil scheme a violation of the statute and the regulation was that the defend-

[1] "The district courts of the United States * * shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder * * * may be brought in any such district, * * * and process in such cases may be served in any other district of which the defendant is an inhabitant * * *" §27, 15 USCA §78aa.

ants directly or indirectly used means or instrumentalities of interstate commerce or of the mails "in connection with the purchase" of the stock from Consolidated. The fraudulent scheme need not be hatched in the forum district. Nor is it necessary that a false or deceptive or fraudulent paper be sent or statement made through the use of the mails or interstate communication facilities. We are of the clear opinion that this is the rule for actions under §10(b) and Rule X-10B-5 regardless of what the proper rule under §12 of the Securities Act of 1933, 15 USCA §77*l*, might be. Cf. *Kemper v. Lohnes*, 7 Cir., 1959, 173 F.2d 44. Practically every case discussing this[12] relies on our earlier opinions in *Kopald-Quinn & Co. v. United States*, 5 Cir., 1939, 101 F.2d 628, cert. denied, 307 U.S. 628, 59 S. Ct. 835, 83 L.Ed. 1511, and *Pace v. United States*, 5 Cir., 1938, 94 F.2d 591. There the selling was done by verbal contact and negotiation with the only use of the mails being transmission of written confirmations of sale. To the contention that to constitute an offense

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[12] United States v. Moajar, 3 Cir., 1944, 147 F.2d 916 at 920 (violations of the Mail Fraud Act, 18 USCA §338 and fraud provisions of the Securities Act, 15 USCA §77q(a) (1), 18 USCA §88. This rule was followed in Northern Trust Co. v. Essaness Theatres Corp., N.D.Ill., 1952, 103 F. Supp. 954, 963-64, and it seems certain that the Third Circuit would apply its *Moajar* rule to a §10(b) case. Slavin v. Germantown Fire Ins. Co., 3 Cir., 1949, 174 F.2d 799 at 814 (dissenting opinion). In all cases the Courts rely on the analogy of the Mail Fraud Statutes citing cases such as Landay v. United States, 6 Cir., 1939, 108 F.2d 698, 701, where the mailing of a stock certificate was held sufficient use of the mails even though that mailing was not itself fraudulent. A mailing need not be deceptive in and of itself; it may be completely innocuous but still sufficient to constitute an offense if connected with the scheme to defraud. Gregory v. United States, 5 Cir., 1958, 253 F.2d 104, 109. And to cause the mails to be used it is sufficient if the use of the mails can reasonably be foreseen though not actually intended. Pereira v. United States, 1954, 347 U.S. 1, 8, 9, 74 S.Ct. 358, 98 L.Ed. 435; see also Abbott v. United States, 5 Cir., 1956, 239 F.2d 310 at 314. "The statute forbids the *use* of the mails as a means of consummating fraud, and if the mail is used in its actual execution, it matters not whether it was intended or anticipated."

under the Securities Act it was necessary to prove a scheme to effect sales and the actual making of sales of securities by mail, we had this to say. "We think the construction thus urged for the Act unduly narrows the language used in it, unduly limits its scope and effect." *Kopald Quinn & Co. v. United States*, *supra*, 101 F.2d 628 at 632.

We think that any use of instrumentalities of the mails or other interstate facilities made within the forum district constituting an important step in the execution of the fraudulent, deceitful scheme or in its consummation is sufficient. Generally speaking we would say that any act which would be sufficient to constitute an offense under the mail fraud, or similar criminal statutes, occurring within the forum district would be adequate to authorize extraterritorial service of process under 27, note 11, *supra*. This approach automatically reads into this Act general provisions such as 18 USCA 3237 designed to overcome the result in *United States v. Johnson*, 1944, 323 U. S. 273, 65 S.Ct. 249, 89 L.Ed. 236, that jurisdiction is in "any district from, through, or into which" interstate commerce or mail matter moves.

Here the facts are alleged with adequate clarity to show a factor of material importance occurring within Alabama. The telephone call from Cage (in Texas or at least outside of Alabama) to management of Consolidated located in Alabama was an occurrence taking place in Alabama as well as Texas. Interstate communication facilities were used within Alabama to cause the transfer of $10,000 to be made to the Cuban insurance company. This was an important step in the consummation of the scheme. Actually, it was also fraudulent since Cage represented that Consolidated already owned the Cuban company and to save its investment, the funds sought and furnished were urgently needed. Thus, here there was a use of interstate

facilities as a means of transmitting a fraudulent statement.

It is apparent that the language in §27, note 11, *supra*, describing the venue district as "the district wherein any act or transaction constituting the violation occurred" cannot mean the district in which all acts took place, or in which the transaction as a whole was consummated. The statute was one designed to put an end to interstate frauds in the sale and trading of securities. The legislative pattern envisages the likelihood that actions would take place in many places requiring the frequent use of instrumentalities of the mail or of communication. The Act meant to vest jurisdiction in every district where any use of such instrumentalities of the mail or interstate commerce was of material importance to the consummation of the scheme.

IV.

The Statute of Limitations.

While the parties did not press this below and the District Court did not pass on it, all defendants assert in support of the correctness of the judgment of dismissal the contention that the complaint showed on its face that the action was not timely brought.

The complaint was filed November 25, 1959. The occurrences complained of took place in October-December 1956. The limitation statutes of the forum state apply to actions of this kind under the SEC Act.[13] The Alabama statutes[14] are unavailing as the complaint was not filed within one

[13] Actions under Rule X-10B-5 the applicable statute of limitations is that of the state in which the Federal Court sits. Tobacco & Allied Stocks v. Transamerica Corp., 3 Cir., 1957, 244 F.2d 902; Pratt v. Robinson, 9 Cir., 1953, 203 F. 2d 627, 634; Connelly v. Balkwell, N.D.Ohio, 1959, 174 F.Supp. 49, 63-64; Errion v. Connell, 9 Cir., 1956, 236 F.2d 447.

[14] Alabama Code Title 7, §§26 and 42

year of the accrual of the claim or within one year after the existence of the fraud was discovered. The Trustee relies on §11(e) of the Bankruptcy Act permitting suits by a Trustee on claims not then time-barred if brought "within two years subsequent to the date of adjudication or within such further period of time as the Federal or State law may permit * * *." 11 USCA §29(e). Consolidated was adjudicated a bankrupt in May 1957. The one-year limitation under Alabama law on fraud had not run at that time. Of course, on the words of the statute standing alone, the two-year period had expired in May 1959, some six months before the complaint was filed.

But this is no insurmountable obstacle for we agree with *Dabney v. Levy*, 2 Cir., 1951, 191 F.2d 201, that the two-year limitation prescribed in §11(e) does not begin to run until the time the fraud reasonably should have been discovered. That Court applied the teaching of *Bailey v. Glover*, 1875, 21 Wall. (88 U.S.) 342, 22 L.Ed. 636, subsequently applied in *Holmberg v. Armbrecht*, 327 U.S. 392, 397, 66 S.Ct. 582, 90 L.Ed. 743, 748, which declared that "this equitable doctrine is read into every federal statute of limitation." See 1 Collier, Bankruptcy ¶11.13, Pages 1188-1189 (1959 Supp.)

The complaint alleges affirmatively that it was filed within two years of the time the fraudulent scheme was discoverable by the use of reasonable diligence. This is adequate to withstand a motion to dismiss. Of course, proof will have to be made and the trial court should be allowed considerable flexibility in adapting procedures for the trial and determination of this threshold issue. Viewing the cases on a record made up of the complaint and a small assortment of letters attached to various motions, we could not undertake to indicate at this juncture whether this issue is sufficiently severable from the intrinsic transactions out of which the fraud is alleged to

have arisen, so that a separate trial would be feasible, the determination of which might conceivably put an end to further costly and difficult litigation. This has been done, but, of course, the trial court must be careful lest a truncated proceeding adversely affect rights.[15]

V.

Standing of Trustee to Sue.

The defendants attack the Trustee's right, title or status to sue on behalf of Consolidated to recover damages or obtain other relief by reason of the alleged fraudulent scheme. They reason that while the SEC Act gives a remedy, what is asserted is essentially a claim for fraud or deceit.[16] Consequently, they contend, the action is one personal to the victim, is not assignable, and therefore does not vest in the Trustee.[17] Akin to this is the further suggestion that if, despite the fraud, the claim is otherwise assignable, it would not be so under §70 of the Bankruptcy Act, 11 USCA §110(a), since, no creditors any longer being adversely affected, the only persons to benefit will be the stockholders, not the corporation. It is the corporation whose property interests are alone transferred to the Trustee by the bankruptcy law.[18]

---

[15] See, e.g., Crummer Co. v. DuPont, 5 Cir., 1955, 223 F.2d 238, especially Crummer Co. v. DuPont, 5 Cir., 1958, 255 F.2d 425, reversing a directed verdict after jury trial on the preliminary issue of limitation; after remand it is our understanding the jury found that limitations had run thus putting an end to the litigation.

[16] They cite Fischman v. Raytheon Mfg. Co., 2 Cir., 1951, 188 F.2d 783; Norris & Hirschberg, Inc. v. SEC, D.C.Cir., 1949, 177 F.2d 228; Pratt v. Robinson, 9 Cir., 1953, 203 F.2d 627; Wm. LaFrance Truck Corp., 13 SEC 372, 381.

[17] They cite Phillips v. Malone, 1931, 223 Ala. 381, 136 So. 763; Wogalin v. Stevens, 1940, 236 Wisc. 122, 294 N.W. 503.

[18] Defendants cite United States v. Jones, 10 Cir., 1956, 229 F.2d 84; Bager v. Jones Cotton Co., 1937, 234 Ala. 103, 173 So. 402.

We think there is nothing to this contention. For the reasons we have set forth in so much detail, Consolidated as a seller sustained a substantial loss measured at least in terms of properties which could have been acquired by the corporation through the issuance of 760,000 shares of its own stock. Such a claim is not one personal to the bankrupt excluded either under express terms of the bankruptcy statute[19] or by general considerations of the law. In any event, since a corporate bankrupt is an inanimate entity, there is respectable authority that an action based on fraud as to a corporation plaintiff is as a matter of law an injury to property. 4 Collier, Bankruptcy, 70.28 (64); see also *Empire Tractor Co. v. Time, Inc.*, E.D.Pa., 1950, 91 F. Supp. 311; *Thomason v. Miller*, Tex.Civ.App., 1928, 4 S.W.2d 668 (writ dism'd). The objection of the absence of any "property" to be transferred fares no better as it is established that a Trustee may enforce liability under state statutes where watered stock has been issued even though no asset was transferred. In Re Pipe Line Oil Co., 6 Cir., 1923, 289 Fed. 698; 4 Collier on Bankruptcy, 70.29.

By reason of the alleged fraud Consolidated parted with that which on its current value could have enabled the corporation to acquire property of substantial value. Instead of getting like value by the purported transfers from Mid-Atlantic, it got nothing. This action seeks damages, accounting for profits and other relief to compensate for that loss sustained by the corporation. That it accrued from fraud makes it no less a loss thought of in terms of property. As to such corporate loss, the Trustee is the sole representative.

---

[19] "§70(a)(5) carries its own exclusion:

"* * * rights of action ex delicto for libel, slander, injuries to the person of the bankrupt or of a relative, whether or not resulting in death, seduction and criminal conversation shall not vest in the trustee. * * *" 11 USCA §110(a)(5).

VI.

Consolidated in Pari Delicto and Other Incidental Defenses.

At least one of the defendants urges that the Trustee cannot recover as the complaint reflects on its face that Consolidated was in pari delicto with the alleged defrauding conspirators. The thesis seems to be this. The complaint alleged that all of Consolidated's stock issued and outstanding as of the time of bankruptcy was "issued in transactions in which the stock was *allegedly* exempt from registration with the" SEC. Later it alleged that the New York defendant falsely represented to the stock transfer agent that the proposed issue of 700,000 shares was exempt from SEC registration. In view of this, so the argument goes, if the stock originally issued by it or the 700,000 shares issued as a result of the fraudulent scheme were subject to SEC registration as the complaint negatively implied, the corporation is in pari delicto and cannot recover.[20] The Trustee is a successor and has no additional standing.

Variations of this attack as well as others are also asserted. One contention is that the complaint showed that Mid-Atlantic had already been dissolved before the 700,000 shares of stock of Consolidated were transferred to it. Consequently there was no "purchaser." On the other hand, it alleged that all of the steps taken by Consolidated were done by and through persons who no longer were officers with authority to bind the corporation. Therefore,

[20] Cited are the cases of Reilly et al. Trustees v. Meade Clyne Ariz. ... 234 P 35, 40 A.L.R. 1005; Miller v. Cal. ... Roofing Co. ... 55 Cal App 2d 136, 130 P 2d 740; Deckert v. Independence Share Corp., 1940, 311 U.S. 282, 61 S.Ct. 230, 85 L.Ed. 189; Rosenberg v. Hano, E.D.Pa., 1940, 30 F.Supp. 774, affirmed, 3 Cir., 1941, 121 F.2d 818.

there was no "seller." The conclusion is thereupon urged that there could have been no sale or purchase in the absence of a seller or a purchaser or both.

A further suggestion is made that in view of these allegations of unauthorized acts by former officers of Consolidated, the stock issue was entirely void even in the hands of bona fide purchasers so that no loss was sustained by Consolidated. The contention is that from Consolidated's standpoint the worst was that the 700,000 shares of stock could have been cancelled either by the corporation or through a derivative suit or the holders could be assessed for par value.[21]

In our judgment none of these contentions has merit. In whatever form, and however stated or restated, these arguments ignore the scheme alleged in the complaint by which these individuals and Mid-Atlantic undertook to get Consolidated to take action which it otherwise would not take and which, but for the misrepresentations and fraud, it would not have taken. That certainly comprehends active misrepresentations resulting in the stock transfer agent issuing 700,000 shares of stock. The theory of the complaint is not that it lost 700,000 shares of stock. Rather, it lost what 700,000 shares of its stock at its then current value would have procured in the acquisition of new properties. A corporation duped by fraud into parting with this valuable capability is certainly not a knowing party to such fraud. It is not confined to a mere cancellation of that stock nor subjected to the expense of multiple litigation against a large number of holders (many perhaps innocent) to assert a claim for the nominal par value (1¢) of this stock, the successful recovery of which would net $7,000, not what 700,000 shares would have purchased.

[21] Defendants cite Delaware Constitution, Art. IX §3; Delaware Code, Title 8, §§152, 163, 164. See, e.g., Baker v. Pinkerton Mortgage Co., 1926, 15 Del. Ch. 183, 133 Atl. 608.

The cause must therefore be reversed and remanded for further consistent proceedings.

Reversed and Remanded.

Cameron, Circuit Judge: I Dissent.

Judgment.

Extract from the Minutes of July 12, 1960.

Perry O. Hooper, as Trustee in Bankruptcy of Consolidated American Industries, Inc.

No. 18218. versus

Mountain States Securities Corporation, et al.

This cause came on to be heard on the transcript of the record from the United States District Court for the Middle District of Alabama, and was argued by counsel;

On Consideration Whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed; and that this cause be, and it is hereby, remanded to the said District Court for further proceedings consistent with the opinion of this Court;

It is further ordered and adjudged that the appellees, Mountain States Securities Corporation, and others, be condemned, in solido, to pay the costs of this cause in this Court for which execution may be issued out of the said District Court.

"Cameron, Circuit Judge, Dissenting."

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IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1960.

No. 603.

MOUNTAIN STATES SECURITIES CORPORATION et al.,
Petitioner,

vs.

PERRY O. HOOPER, as Trustee in Bankruptcy of
CONSOLIDATED AMERICAN INDUSTRIES, INC.,
Respondent.

BRIEF ON BEHALF OF RESPONDENT.

TRUMAN M. HOBBS.

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IN THE

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Petitioner,

vs.

PERRY O. HOOPER, as Trustee in Bankruptcy of
CONSOLIDATED AMERICAN INDUSTRIES, INC.,
Respondent.

BRIEF ON BEHALF OF RESPONDENT.

QUESTIONS PRESENTED

Section 10 (b) of the Securities Exchange Act of 1934[1] and SEC Rule X-10B-5 promulgated pursuant to the Act[2]

[1] 15 U. S. C. § 78j (b).

[2] 17 C. F. R. 240.10b-5.

declare unlawful, in broad language, interstate fraud in connection with the purchase or sale of securities. The principal question presented by the Petition, and the principal question decided below is whether a corporation which has been defrauded in a transaction in which it acquires worthless securities is denied the protection of Section 10 (b) and Rule X 10B-5 because it paid for the purchase in its own stock?. The refusal of the Fifth Circuit to exclude such a transaction from the scope of Section 10 (b) has occasioned the Petition here.

Ancillary to the central question of the application of Section 10 (b) are the questions raised below and decided against petitioners relating the statute of limitations and whether respondent selected the proper forum in the bringing of the suit.

STATEMENT OF THE CASE.

There is no evidence in this case. The appeal to the Fifth Circuit was from an order dismissing the complaint for failure to state a cause of action. The complaint describes in some detail a complex interstate fraud in which petitioners and others participated. The result of the fraudulent scheme was the issuance of 700,000 shares of the bankrupt's capital stock in exchange for valueless securities.

Petitioners in their commendable efforts at brevity have over-simplified the statement of the facts and the case, and have failed to recite material portion of the complaint. Respondent would adopt as a fair, succinct statement of the case the recitation of the fraudulent scheme by the Fifth Circuit (Petitioner's Brief, pp. 25-28).

REASONS IN OPPOSITION TO THE GRANTING OF THE WRIT.

I.

The Securities Act Questions.

In 1942 the SEC, acting under the powers granted it under Section 10 promulgated Rule X-10B-5 declaring it to be unlawful in connection with the purchase or sale of any security in interstate commerce:

> "(1) to employ any device, scheme or artifice to defraud,
>
> "(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . ."

Since **Kardon v. National Gypsum Co.**, 69 F. Supp. 512 (E. D. Pa.), the Courts have consistently recognized that a violation of Section 10 or Rule X-10B-5 gives rise to a private right of action, and this position has been favorably received by the commentators.

Petitioners here urge that (1) there was no sale and (2) that respondent, or his bankrupt are not within the class

Fischman v. Raytheon Mfg. Co., 188 F. 2d 783, 2d Cir. 1951; Fratt v. Robinson, 203 F. 2d 627, 6th Cir. 1953; Ferraiolo v. Newell, 286 F. 2d 445, 5th Cir. 1960; Shaw v. Germantown Fire Ins. Co., 174 F. 2d 799, 3d Cir. 1949; Matheson v. Niagara Chemical Co., 6th Cir., No. 16,067, November 28, 1961.

See 59 Yale Law Journal 1129, "The Expansion of Rule X-10B-5: An Emerging Remedy for Defrauded Investors", 45 Minn. Law Review 23 (Oct. 1960), "The Securities Regulation of Stock

benefited by Section 10 and the Rule because the bankrupt was an issuing corporation.

Petitioners charge that the Court below found that the complaint charged "an arrangement" in which securities were "otherwise disposed of" by taking out of context the definition of a sale from Section 3 (a) (14) of the Act. But petitioners have read the Court's opinion out of context. The opinion states:

> "Certainly the transactions between Consolidated and the apparent transferee, Mid-Atlantic, had many earmarks of a sale. Mid-Atlantic had properties which it ostensibly valued highly. It was willing to trade these properties as consideration for the Consolidated stock. Consolidated, on the other hand, had its own stock which had a marketability of $1 per share. To the corporation it had the same economic value as would the proceeds received from a public issue of like shares to acquire property which it desired and which it had been led to believe was valuable. Before the transaction Consolidated had 700,000 shares of stock. After the transaction it no longer had the stock, but if had, or thought it had, the property. If this is not a sale in the strict common law traditional sense, it certainly amounted to an arrangement in which Colsolidated 'otherwise di posed(d) of' its stock. § 3 (a) (14), 15 U. S. C. A. 78c (a) (14)."

The primary target of the Act and the Rule is fraudulent conduct in connection with security transactions. "Sale" and "sell" are given extremely broad statutory definitions so that, as to cases under Section 10, sophistication of the fraud will not destroy the remedy. Here 700,000 shares of stock were issued by the stock transfer agent of the bankrupt as a result of an elaborate scheme under which two worthless contract rights were transferred to the bankrupt in consideration for the stock.

Before the exchange the bankrupt had its shares. After the exchange it no longer had the shares. The transaction was as much a sale as the "sale" of stock in a fictitious corporation for cash. What Congress has sought to prohibit are "crooked deals" involving securities. It would be strange indeed if the "crooked deal" involving the securities in this case was taken out of the Act's protection because it was so crooked that the deal could not be designated as a sale. Congress has not put such a premium on the ingenuity of the particular fraud.

The objection made by petitioners could be made in almost any Section 10 (b) case. The only qualification would be the establishment of a fraud of sufficient magnitude to permit a court to declare the transaction void. But such a result would merely force the fraudulent actor to return the cookie to the jar. And this remedy has existed long before the Act. Indeed it was the inadequacy of the remedy which underlies the enactment of Section 10 and the Rule.

Petitioners assail the holding below because they contend that the bankrupt, as the issuing corporation was not within the class sought to be protected. Petitioners' argument is climaxed with the assertion that there is adequate protection to the bankrupt without resorting to Section 10 and Rule X-10B-5. The clear inadequacy of the suggested remedies is one of the most compelling reasons for recognition of respondent's claim here.

The bankrupt is a Delaware corporation. Under the Delaware constitution and statutes the corporation or its trustee in bankruptcy can elect to sue to cancel the stock issued without consideration or assess the holders for par value. Even Petitioners do not suggest that recovery by

[illegible] v. Robinson, supra,

[illegible] v. [illegible], supra,

[illegible] 54

le par on stock selling on the market at the time of the fraud at a price in excess of $1.00 per share is an adequate remedy. It is not unusual for the par value of a stock to bear little or no relationship to its market value. To permit the par value to be the sole and arbitrary measure of recovery for the amount due on stock fraudulently procured by use of interstate instrumentalities is an open invitation to the manipulators.

The complaint also demonstrates the hopelessness of the alternative right to sue to cancel. According to the complaint in excess of 400,000 of the original 700,000 shares are in the hands of numerous persons throughout the country and abroad. We think it a fair, and indeed almost inescapable conclusion that many of these persons paid value for their shares without notice of the fraudulent circumstances under which the shares went on the market.

The Fifth Circuit treated the case as one in which the securities involved were the 700,000 shares. It could have also considered the rights to acquire securities, which rights formed the purported consideration for the stock, as the securities involved in the transaction. Thus the bankrupt can be considered as a purchaser investor or a seller investor.

If the assets transferred to the bankrupt were securities within the Act, or if part of the assets can be so classified, the bankrupt is a "purchaser" investor and we will assume that petitioners would concede that the bankrupt was within a protected class. The Circuit Court did not deem it necessary to pass on the status of the bankrupt as a purchaser since it found it to be a seller.

The "consideration" moving from the bankrupt was admittedly a "security," within the Act. It was also a security of value. As commented below, the use of watered stock as a means of expanding and acquiring investments is common. The investment of previously unissued

shares rather than cash or some other asset does not change the fact of the investment nor should the issuer be deprived of the Act's protection against fraud because of this mean of acquiring assets.

The status of respondent is not adversely affected by Petitioners' reliance upon, and quote from **Howard v. Furst**, 238 F. 2d 790 (2 Cir. 1956). The **Howard** case declared that a corporation through a derivative suit could not complain of fraud in connection with proxies fraudulently solicited in alleged violation of Section 14 (a) of the Act.

Congress has recognized the inadequacy of the common law fraud remedies to deal with nationwide schemes to defraud in security transactions. The history of Section 10 and Rule X-10B-5 is one of increased judicial application of the Section and its Rule to such fraudulent schemes. No reason is advanced by Petitioners why the present case should begin the retreat to horse and buggy remedies in jet age security frauds.

II.

Alabama as a Proper Forum.

We do not conceive Petitioners to argue that Section 27 of the Act requires that all events constituting a violation of Section 10 and the Rule must occur within a particular district before that district court could have jurisdiction. Security frauds are just not that simple. Nor do Petitioners argue that the Fifth Circuit was in error in stating that "The Act meant to vest jurisdiction in every district where any use such instrumentalities of the mail or interstate commerce was of material importance to the consummation of the scheme."

Before the shares be issued it was necessary for the conspirators to obtain the contract rights which they pro-

posed to transfer to the bankrupt. As the complaint alleges, the central figure of the whole fraudulent scheme was one Ben Jack Cage, who is not a party because he is a fugitive from justice and believed to be in the Republic of Brazil. In order to obtain the contract right to acquire the stock of the Cuban insurance company, Cage, from outside Alabama, telephoned the bankrupt's officers in Alabama and fraudulently represented that the bankrupt already owned the Cuban company and that unless $10,000 was immediately sent to Cuba, a valuable investment would be lost. The money was then sent and was used by Cage to acquire the right to purchase the stock of the Cuban company.

Petitioners' theory is that since this Court held in **United States v. Johnson**,[7] that in a prosecution for violation of Federal Denture Act against the person mailing in violation of the Act could be maintained only in the district of origination, this action can be maintained only in the district from which Cage telephoned Alabama. If this action were a criminal prosecution, Petitioners seemingly would concede that Alabama would be one of the forums in which the prosecution could be carried on since they do not dispute that 18 USC Section 3237 was enacted to overcome the **Johnson** case. Nor do they contend that Congress cannot under the circumstances authorize suit in a forum like Alabama.[8]

[7] 323 U. S. 65, 65 S. Ct. 249, 89 L. Ed. 236.

[8] The clear language of the *Johnson* case prohibits such an argument:

"Must these appellees be tried in the Northern District of Illinois or may they be tried in the district of any State through which the dentures were carried, including Delaware, the place of delivery? Had Congress authorized such discretion in the enforcement of this Act? If it has, there is an end to the matter, for Congress may constitutionally make the practices which led to the Federal Denture Act triable in any federal district through which an offending denture is transported." 323 U. S. at p. 274.

It would be strange indeed if a criminal proceeding can be sanctioned in Alabama and a civil action is not permitted. The clear answer, and that announced below is that the general provisions governing interstate transmissions such as 18 U. S. C. 3237 must be read into the enforcement sections of the present Act.

III.

The Statute of Limitations.

The Alabama statutes governing limitations on fraud actions provide for one year or one year after discovery.[9] The fraud took place in October-December, 1956. The bankrupt was adjudicated in May, 1957. The complaint alleges that the action was commenced within two years of discovery.

Section 11 (c) of the Bankruptcy Act[10] provides that the trustee shall have two years within which to sue on a claim of the bankrupt not barred as of the date of adjudication. Does the two year limitation of Section 11 (c) permit two years after discovery of fraud cases?

The answer to this contention below was short:

> "But this is no insurmountable obstacle for we agree with Dabney v. Levy, 2 Cir., 1951, 191 F. 2d 201, that the two-year limitation prescribed in § 11 (c) does not begin to run until the time the fraud reasonably should have been discovered. That Court applied the teaching of Bailey v. Glover, 1875, 21 Wall. (88 U. S.) 342, 22 L. Ed. 636, subsequently applied in Holmberg v. Armbrecht, 327 U. S. 392, 397, 66 S. Ct. 582, 90 L. Ed. 743, 748, which declared that 'this equitable doctrine is read into every federal statute

[9] Title 7, §§ 26 and 42, Code of Alabama, 1940, set forth in Petitioner's Brief, pp. 6-7.

[10] 11 U. S. C., § 29 (c), set forth in Petitioner's Brief, p. 6.

of limitations.' See 1 Collier, Bankruptcy, ¶11.15, pages 1188-1189 (1959 Supp.)."

The reason for the rule is stated at 5 A Remington on Bankruptcy, Section 2349.1, p. 52:

> "It is a rule of general application that courts of equity, though they will ordinarily apply limitation provisions, are not strictly bound thereby, at least unless the statute is so clearly intended to apply in equity as well as law to make it imperative; and where a cause of action is based on fraud, they will not consider such cause of action to have accrued until discovery of the fraud or coming into knowledge of facts sufficient to place an inquiry which would have led to such discovery. This principle must be read into § 11 of the Bankruptcy Act, and in instances of excusable delay in discovery of fraud, it can have the effect of leaving a cause of action not barred, and suit by a trustee to enforce it not too late, though suit is not commenced until after expiration of both the stated limitation period under states law and the two-year period after adjudication of bankruptcy."

CONCLUSION.

The opinion below is correct. The questions sought to be raised here were treated at length there. The holding below is consonant with the other circuits. The petition should be denied and Respondent permitted to reach the merits of his case.

Respectfully submitted,

TRUMAN HOBBS,
P. O. Box 347,
Montgomery, Alabama,
Counsel for Respondent.

Certificate of Service.

I, Truman Hobbs, attorney for Respondent, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the ..... day of January, 1961, I have served copies of the above brief as follows:

1. On the Securities Exchange Commission, by mailing a copy in a duly addressed envelope with air mail postage prepaid, to Thomas G. Meeker, its general counsel, at the offices of the Commission, Washington 25, D. C.

2. On attorneys for the petitioners by mailing a copy in a duly addressed envelope with first class postage prepaid to Jack Crenshaw, 701 First National Bank Building, Montgomery 4, Alabama; Joseph F. Johnston, 902 First National Building, Birmingham 3, Alabama; and James C. Barton, 822 Brown Marx Building, Birmingham 3, Alabama.

.....

Attorney for Respondent.

P. O. Box 347,
Montgomery, Alabama.

COPY

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No. 603

In the Supreme Court of the United States

OCTOBER TERM, 1960

MOUNTAIN STATES SECURITIES CORPORATION, ET AL., PETITIONERS

v.

PERRY O. HOOPER, as Trustee in Bankruptcy of CONSOLIDATED AMERICAN INDUSTRIES, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION, AS AMICUS CURIAE, IN OPPOSITION

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION, AS AMICUS CURIAE, IN OPPOSITION

The Solicitor General submits this brief on behalf of the Securities and Exchange Commission, as *amicus curiae*, in opposition to the petition for a writ of certiorari. The Commission appeared in the Court of Appeals in support of the position of the respondent.

OPINIONS BELOW

The opinion of the Court of Appeals (Pet. 24-44) is reported at 282 F. 2d 195. The opinion of the District Court (Pet. 19-23) is unreported.

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was entered on July 12, 1960 (Pet. 44). Timely petitions for rehearing were filed and rehearing was denied on September 26, 1960. The petition for a writ of certiorari was filed on December 27, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1). See also Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. 78aa.

QUESTIONS PRESENTED

1. Whether an issuing corporation may have a right of action under Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j, and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, for fraud in the purchase of its previously unissued stock.

2. Whether venue is properly laid in the district where an interstate communication in furtherance of a fraudulent scheme in violation of Section 10(b) and Rule 10b-5 was received.

3. Whether the federal doctrine that the bar of limitations does not commence to run until the fraud was or reasonably should have been discovered is to be applied with respect to the limitations provision in Section 11(e) of the Bankruptcy Act, 11 U.S.C. 29(e).

STATUTES INVOLVED

Pertinent provisions of the Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. 78a, *et seq.*, and of the Bankruptcy Act, 30 Stat. 544, as amended, 11 U.S.C. 1, *et seq.*, are set forth in the petition (Pet. 4-6).

STATEMENT

Perry O. Hooper, as trustee in bankruptcy of Consolidated American Industries, Inc. (Consolidated), brought suit in the United States District Court for the Middle District of Alabama against the petitioners, all of whom are non-residents of Alabama. Invoking the jurisdiction of the District Court under Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. 78aa, the complaint charged that Consolidated was injured as a result of petitioners' fraudulent conspiracy in violation of Section 10(b), 15 U.S.C. 78j, of that Act and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. The trustee sought an accounting and damages on behalf of Consolidated. Motions to dismiss the complaint and quash service of process were granted by the District Court on the theory that a corporation, whose own previously unissued stock was fraudulently purchased, was not entitled to sue under Section 10(b) and Rule 10b-5.

The essential facts as set forth in the complaint are as follows:

One Ben Jack Cage had controlled Consolidated and had been an officer and director thereof (R. 4). On October 18, 1956, Cage resigned as an officer and

director in favor of a new management (R. 5). Shortly thereafter, Cage conspired with the petitioners to obtain 700,000 shares of Consolidated's unissued capital stock in exchange for certain assets of another corporation, Mid-Atlantic Development Company (Mid-Atlantic), which was owned by Cage and the petitioners (R. 8, 9.). These assets, consisting of certain purported rights to purchase stock of a Cuban insurance company and to acquire certain oil concessions located in Honduras, were presumably without value (R. 7, 8, 14). To obtain for Mid-Atlantic the right to purchase the Cuban insurance company stock, Cage, through interstate communications to the new management of Consolidated in Montgomery, Alabama, made false representations whereby Consolidated was induced to send $10,000 to Havana, Cuba (R. 9, 10). Thereafter, the petitioners' scheme was consummated through the preparation and presentation to Consolidated's transfer agents of certain spurious documents purporting to evidence authorization for the issuance of 700,000 of Consolidated's shares in exchange for the "rights" owned by Mid-Atlantic (R. 10, 11, 12, 13). During this period, Consolidated's shares were selling from $1.00 to $2.75 per share (R. 5).

The trustee in bankruptcy did not discover the fraudulent conspiracy nor did he come into knowledge of facts sufficient to place him on inquiry which would have reasonably led to discovery thereof within two years of the commencement of the action (R. 94).

The Court of Appeals for the Fifth Circuit reversed the judgment of the District Court and re-

manded the action for further proceedings. The Court of Appeals held (1) that a corporation which is fraudulently induced to issue its stock without consideration is entitled to bring an action based on a violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5, (2) that an interstate telephone call received in the Middle District of Alabama in furtherance of the fraudulent scheme constituted an act occurring within that district, so as to satisfy the venue requirements of Section 27 of the Securities Exchange Act of 1934, and (3) that the two-year limitation prescribed in Section 11(e) of the Bankruptcy Act governing actions brought by the trustee does not commence to run until the time the fraud was or reasonably should have been discovered by the trustee.

ARGUMENT

1. The proposition that a violation of Rule 10b-5 gives rise to a private right of action, although of substantial importance and never passed upon by this Court, has been established in three Courts of Appeals in addition to the court below, and is clearly correct. There is no conflict. As the court below noted (Pet. 30): "along with the Second, Third and Ninth Circuits, we now adopt, as we earlier foreshadowed, the principles set forth in the trail-blazer decision of *Kardon* v. *National Gypsum Co.*, E. D. Pa., 1946, 69 F. Supp. 512, that a violation of rule 10b-5 gives rise to a private right of action."

In the instant case, the court applied this doctrine

to a situation where a corporation, in the issuance of its own stock, is injured by conduct violative of the rule. Petitioners contend (Pet. 12-13) that an issuing corporation cannot be considered an investor and, hence, is not within the class intended to be protected by Section 10(b) of the Securities Exchange Act and Rule 10b-5; accordingly, they urge that no private right of action arises in the corporation's favor from the violation, since such a right is implied only on behalf of those injured by the breach for whose protection the statutory duty is created. As the court below noted, however, the Commission was empowered to promulgate rules under Section 10(b) "in the public interest" *or* "for the protection of investors" (Pet. 4). In view of the statutory purpose (set forth in Section 2 of the Act) "to insure the maintenance of fair and honest markets" with respect to securities transactions, the Commission "in the public interest", as well as "for the protection of investors", properly made unlawful (where jurisdictional media are used) the purchase through fraudulent means of any security, not excluding previously unissued stock of a corporation. Thus, the Court of Appeals correctly held that a corporation, the unissued stock of which was so purchased and which was thereby directly injured by a violation of the rule, falls within the segment of the public for whose protection the statutory duty was created, *i.e.*, a defrauded seller of securities.

This holding does not, as petitioners assert (Pet. 11), conflict with *Howard* v. *Furst*, 238 F. 2d 790 (C.A. 2), certiorari denied, 353 U. S. 937. That case

was not concerned with the provisions of the statute or the rule involved here. It upheld the dismissal of a stockholders' derivative action brought, *inter alia*, to rescind the sale of their corporation's assets to another corporation, upon the basis of allegations that the required consent of the stockholders had been obtained through violation of the Commission's proxy rules, 17 C.F.R. 240.14a-1—14a-11, adopted pursuant to Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(a). The court below properly refused to interpret the language of that case, quoted by petitioners, as going beyond the confines of Section 14(a).

The court below also properly decided that the transaction, which took the form of a sale of stock by the issuing corporation to the petitioners, although in fact the sale was completely spurious, was a transaction intended to be outlawed by Section 10(b) and Rule 10b-5. This holding is analogous to that in such cases as *Seeman* v. *United States*, 90 F. 2d 88, 89 (C.A. 5), certiorari denied, 305 U. S. 620, to the effect that a defendant may violate the provisions of the Securities Act of 1933 prohibiting fraudulent sales of securities even though the securities sold were forged.

2. The question with respect to venue was properly decided by the court below and is not in conflict with the holding of this Court in *United States* v. *Johnson*, 323 U.S. 273, as petitioners contend (Pet. 14-15). In *Johnson*, the Court affirmed a judgment quashing an information for violation of the Federal Denture Act of 1942, 56 Stat. 1087 (now 18 U.S.C.

1821),[1] on the ground that the prosecution of the sender of dentures illegally into a state could not be laid in the state of the importer; the Court reasoned that the crime of the sender was distinct from the crime of the importer, and hence was completed where and when the illegal merchandise was deposited in the mails. But this Court also noted (*id.* at 274) that "Congress may constitutionally make the practices which led to the Federal Denture Act triable in any federal district through which an offending denture is transported", citing *Armour Packing Co.* v. *United States*, 209 U.S. 56.[2] The venue provisions of Section 27 of the Securities Exchange Act (Pet. 5-6) sanction both civil and criminal suits in any district, *inter alia*, "wherein any act or transaction constituting the violation occurred". Since, as noted by the court below, the interstate telephone call received here in the Middle District of Alabama "was an important step in the consummation of the scheme" (Pet. 37) violative of Section 10(b) of the Securities Exchange Act and Rule 10b-5, the court correctly held it was sufficient to authorize the venue

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[1] The Federal Denture Act, at that time, 18 U.S.C. (1910 ed., Supp. III) 420f, g, h, made it unlawful, "in the course of the conduct of a business of constructing or supplying dentures from casts or impressions sent through the mails or in interstate commerce, to use the mails or any instrumentality of interstate commerce for the purpose of sending or bringing into * * *" a state or territory any denture the cast of which was taken by a person not licensed to practice dentistry in the state into which the denture is sent.

[2] See also, *e.g.*, *In re Palliser*, 136 U.S. 257, 266; *Benson* v. *Henkel*, 198 U.S. 1, 15; *Salinger* v. *Loisel*, 265 U.S. 224.

and the extra-territorial service of process provided by Section 27.

Moreover, as indicated in the petition (Pet. 6, 15), subsequent to *Johnson*, Congress adopted 18 U.S.C. 3237, which provides in pertinent part:

> Any offense involving the use of the mails, or transportation in interstate or foreign commerce, is a continuing offense and, except as otherwise expressly provided by enactment of Congress, may be inquired of and prosecuted in any district from, through, or into which such commerce or mail matter moves.

The court below properly read this provision into Section 27 of the Securities Exchange Act. Cf. *United States* v. *Cashin*, 281 F. 2d 669 (C.A. 2).[3]

3. As to whether the trustee's cause of action was, on the face of the complaint, barred by the two-year limitation embodied in Section 11(e) of the Bankruptcy Act, we submit that the court below, agreeing with *Dabney* v. *Levy*, 191 F. 2d 201 (C.A. 2), correctly applied the principles announced by this Court in *Bailey* v. *Glover*, 21 Wall. 342, and *Holmberg* v. *Armbrecht*, 327 U.S. 392, that a limitations period does not begin to run until the fraud is (or should be) discovered. In *Dabney*, Judge Learned Hand, writing for the court, concluded (191 F. 2d at 205-206):

> * * * This we take to mean that in cases of "fraud," used to include at least instances of the kind at bar, when Congress does not choose ex-

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[3] See, also, *Travis* v. *United States*, No. 10, this Term, decided January 16, 1961.

pressly to say the contrary, the period of limitation set by it only begins to run after the injured party has "discovered, or has failed in reasonable diligence to discover" the wrong. * * * Indeed it would be monstrous if so bare-faced a taking of this corporation's funds as is here displayed were to escape restitution because the confederates had succeeded in keeping the transaction from detection for six years.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 603.

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SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1960.

MOUNTAIN STATES SECURITIES CORPORATION et al.,
Petitioners,

v.

PERRY O. HOOPER, as Trustee in Bankruptcy of
CONSOLIDATED AMERICAN INDUSTRIES, INC.,
Respondent.

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REPLY BRIEF ON BEHALF OF PETITIONERS.

The petitioners address this brief to an issue which has been raised by respondent in his brief but which was not passed on by the court below and is not before this Court on petition for writ of certiorari.

I.

The Jurisdictional Question.

All parties are agreed that in the case at bar, in order to support jurisdiction under § 27 of the Securities Exchange Act, 15 U. S. C. § 78aa, there must be a showing of

either a purchase or a sale of securities. The court below held that there was a sale of securities by the bankrupt corporation. The petitioners contend that this holding was erroneous; the respondent, that it was correct. The respondent now further argues[1] that even if there was no sale of securities by the bankrupt corporation, there was a purchase of securities by it. This latter argument, which was not passed on by the court below,[2] is without legal or factual substance.

First: The complaint shows that the assets of Mid-Atlantic were not "securities" within the meaning of §§ 33 (a) (14) and 10 (b) of the Securities Exchange Act, 15 U. S. C. § 78c (a) (14), 78j (b).

Second: Although the complaint alleges in general terms that the original conspiracy was for the purpose of obtaining the shares of the bankrupt corporation in exchange for the assets of Mid-Atlantic Development Company (R. 9), the complaint specifically alleges that the 700,000 shares were obtained without the contemporaneous or prior transfer to the corporation of the Mid-Atlantic assets (R. 10-14). Further, the complaint fails to allege that these assets were *ever* transferred to the corporation. Nor is there any allegation that the corporation ever received any offer of the assets. On the contrary, the complaint alleges that Ben Jack Cage represented to the corporation that it already owned these assets (R. 9, 10).

Third: Even if the assets of Mid-Atlantic had been securities and had in fact been unilaterally transferred to the bankrupt corporation, such transfer would not have constituted a "purchase" by the corporation. According to the complaint, the entire transaction took place without

[1] Brief of Respondent, p. 6.

[2] Opinion of the Court of Appeals, as set forth in the Petition, p. 28.

the participation, knowledge or authority of the corporation. One can be a grantee, devisee, assignee, or donee without any act on his part, but one cannot be a purchaser without taking some action. Nor can one be a seller without performing some act of sale. The act of the corporation's independent transfer agent in physically delivering the stock certificate was not an act of purchase or of sale.

II.

The Venue Question.

When the argument that there was a purchase of securities falls, it carries with it the argument that a relevant act took place in Alabama. Under the allegations of the complaint the critical event—that is, the event upon which respondent bases his claim of injury—was the delivery of the stock certificate by the bankrupt corporation's transfer agent. It is obvious that such delivery did not constitute a purchase by the corporation. Nor did it constitute a sale. But even if—as held by the court below—such delivery had constituted a sale, in order to support venue in Alabama the complaint would have had to show some act in Alabama connected with such sale. This the complaint failed to do.

The only act alleged to have occurred in Alabama was a misrepresentation made by Ben Jack Cage to obtain $10,000 so that he could purchase *for himself* and his alleged conspirators assets which later became part of the so-called Mid-Atlantic assets. Whatever may be the proper remedy for the recovery of this $10,000, whether under the Securities Exchange Act or otherwise, it is clear that this was a separate wrong. Neither the existence or non-existence, value or lack of value, nor transfer or failure to transfer these assets had any connection with the delivery of the stock certificate by the corporation's transfer

agent. This delivery, according to the complaint, was made in reliance upon fictitious corporate resolutions, not in contemplation of or in connection with the Mid-Atlantic assets.

Respectfully submitted,

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Proof of Service.

I, Jos. F. Johnston, one of the attorneys for Mountain States Securities Corporation, Bruce Kistler, G. Harold Pearson, Ivor C. Peterson, Hoch Reid and Francis J. Knoll, petitioners herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that

on the ..... day of February, 1961, I served copies of the above and foregoing Reply Brief as follows:

1. On the United States, by mailing a copy in a duly addressed envelope, with air mail postage prepaid, to The Solicitor General, Department of Justice, Washington 25, D. C.

2. On the Securities Exchange Commission, by mailing a copy in a duly addressed envelope, with air mail postage prepaid, to Walter P. North, its general counsel, at the offices of the Commission, Washington 25, D. C.

3. On Perry O. Hooper, as trustee in bankruptcy of Consolidated American Industries, Inc., by mailing a copy in a duly addressed envelope, with first class postage prepaid, to his attorney of record, Truman M. Hobbs, Esq., Godbold, Hobbs & Copeland, 300 Professional Center, Montgomery, Alabama.

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